91-1649

No. _____

Supreme Court, U.S.
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In The

Supreme Court of the United States

October Term, 1991

AUGUST J. HAUPTLI, JR. and
BARBARA HAUPTLI,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Petition For Writ Of Certiorari To The United States Court Of Appeals For The Tenth Circuit

PETITION FOR WRIT OF CERTIORARI

THOMAS J. KENNEDY
KENNEDY BERKLEY YARNEVICH
& WILLIAMSON, CHARTERED
710 United Building
Salina, KS 67401
(913) 825-4674
Counsel of Record for Petitioners

COCKLE LAW BRIEF PRINTING CO., (800) 225-6964
OR CALL COLLECT (402) 342-2831

QUESTION PRESENTED

At issue is an income tax statute, 26 U.S.C. § 46(e)(3), in effect for taxable year 1983 which provides in pertinent part that an investment tax credit shall be allowed a noncorporate lessor of qualified property if "the term of the lease (taking in account options to renew) is less than 50 percent of the useful life of the property". The question presented is:

For the purpose of the income tax statute involved, should the term of a written lease between an individual taxpayer and an unrelated entity be measured by application of the "realistic contemplation" test approved by the United States Court of Appeals for the Tenth Circuit or should the term of the lease be measured in accordance with the "economic risk" standard enunciated by the United States Court of Appeals for the Seventh Circuit?

PARTIES TO THE PROCEEDINGS

The names of all parties to the proceedings in the Court below appear in the caption of this case.

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No. _____

In The

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October Term, 1991

AUGUST J. HAUPTLI, JR. and
BARBARA HAUPTLI,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Petition For Writ Of Certiorari To The United States Court Of Appeals For The Tenth Circuit

PETITION FOR WRIT OF CERTIORARI

Petitioners, August J. Hauptli, Jr. and Barbara Hauptli, respectfully petition for a writ of *certiorari* to review the judgment of the United States Court of Appeals for the Tenth Circuit entered in this case on December 19, 1991. Petitioners' request for a rehearing was denied by the Court of Appeals on January 21, 1992.

OPINIONS BELOW

The decision of the Court of Appeals for the Tenth Circuit is reported at 951 F.2d 1193 (10th Cir. 1991), and is

reprinted as Appendix A. The order of the Court of Appeals denying the petition for rehearing is reprinted as Appendix B. The Supplemental Memorandum Opinion of the United States Tax Court filed February 26, 1991, T.C. Memo 1991-72, is reported at 61 T.C.M. (CCH) 1964 (1991) and is reprinted as Appendix C. The decision of the United States Tax Court entered pursuant to its Supplemental Memorandum Opinion is reprinted as Appendix D. An earlier decision of the Court of Appeals for the Tenth Circuit reversing and remanding the original memorandum opinion and decision of the United States Tax Court is reported at 902 F.2d 1505 (10th Cir. 1990) and is reprinted as Appendix E. The original Memorandum Findings of Fact and Opinion of the United States Tax Court filed November 7, 1988, T.C. Memo 1988-518, is reported at 56 T.C.M. (CCH) 583 (1988) and is reprinted as Appendix F.

JURISDICTION

The judgment of the United States Court of Appeals for the Tenth Circuit was entered in this case on December 19, 1991. A petition for rehearing was timely filed by the petitioners and on January 21, 1992 the Court of Appeals entered its order denying the petition for rehearing. Jurisdiction to review this case by writ of *certiorari* is conferred on this Court by 28 U.S.C. § 1254(1). Such jurisdiction is invoked by filing this petition for a writ of *certiorari* within 90 days from January 21, 1992, as provided by 28 U.S.C. § 2101(c) and Supreme Court Rule 13.

STATUTORY PROVISIONS INVOLVED

In 1983 petitioners claimed an investment tax credit under 26 U.S.C. § 46(e)(3) then in effect, which provided in pertinent part that an investment tax credit shall be allowed a noncorporate lessor of qualified property if, among other requirements, "the term of the lease (taking into account options to renew) is less than 50 percent of the useful life of the property". Title 26 U.S.C. § 46(e)(3) in effect for 1983 is reprinted in its entirety as Appendix H.

STATEMENT OF THE CASE

This is a federal income tax case involving taxpayers who are noncorporate lessors and who in 1983 claimed an investment tax credit of $14,135 under 26 U.S.C. § 46(e)(3) then in effect. Investment tax credit was claimed for 1,000 new compressed gas cylinders purchased at a cost of $141,350 and leased to an unrelated party during 1983 pursuant to a written Wholesale Cylinder Rental Agreement. With respect to leased property, the statute involved allows an investment tax credit to a noncorporate lessor if the term of the lease (taking into account options to renew) is less than 50 percent of the useful life of the property. Here, the taxpayers leased the 1,000 compressed gas cylinders for a stated initial term of 5 years, which is less than 50 percent of the 35-year useful life of the gas cylinders. The lease contained no option to renew, but provided that after the expiration of the initial term it shall remain in force on a year-to-year basis until terminated by either party as of the expiration of the

stated initial term or as of any anniversary date thereafter.

Applying a subjective test known as the "realistic contemplation" test, the United States Court of Appeals for the Tenth Circuit affirmed a decision of the United States Tax Court holding that the taxpayers did not show that it was the realistic contemplation of the parties to terminate the lease at the end of the stated 5-year initial term. Thus, the Tax Court concluded that the lease was for an indefinite term and the gas cylinders in issue did not qualify for the investment tax credit because such an indefinite lease does not meet the 50 percent requirement of the statute.

The Tax Court had original jurisdiction over the case pursuant to 26 U.S.C. § 6213 and § 7442. The Tax Court filed its original Memorandum Findings of Fact and Opinion on November 7, 1988, and entered its Decision on November 10, 1988. On January 9, 1989 a timely notice of appeal of the decision was filed by the petitioners in accordance with 26 U.S.C. § 7483. The petitioners are residents of Salina, Kansas. The Court of Appeals for the Tenth Circuit had jurisdiction to hear the appeal pursuant to 26 U.S.C. § 7482.

On May 8, 1990, the Court of Appeals for the Tenth Circuit issued its opinion reversing and remanding the case to the Tax Court for further proceedings in accordance with the opinion of the Court of Appeals. On February 26, 1991 the Tax Court issued a Supplemental Memorandum Opinion deciding the case against the taxpayers and on March 6, 1991 the Tax Court's decision on remand was entered. Again, a timely notice of appeal was

filed and the case was reviewed by the Court of Appeals for the Tenth Circuit. On December 19, 1991, the Court of Appeals for the Tenth Circuit filed its opinion and judgment affirming the Tax Court's decision on remand in the case. A petition for rehearing was timely filed with the Court of Appeals for the Tenth Circuit, but was denied by order entered January 21, 1991. This petition for a writ of *certiorari* follows.

REASONS FOR GRANTING THE WRIT

This Court's Rule 10.1(a) provides that a review by *certiorari* may be considered appropriate when a United States Court of Appeals has rendered a decision in conflict with a decision of another United States Court of Appeals on the same matter. U.S. Sup. Ct. R. 10.1(a). Particularly in tax cases, *certiorari* is warranted to resolve a conflict between different courts of appeal on a matter of importance to the proper interpretation and uniform application of internal revenue laws. *Turnbow v. Commissioner*, 368 U.S. 337, 339 (1961). This case satisfies that criteria. Except for an important subsidiary issue involving the taxpayers' burden of proof, the question presented in this case has been resolved for future years by reason of the Tax Reform Act of 1986 which repealed the investment tax credit provision involved in this case. Nevertheless, the question remains one of substantial importance in the administration of the income tax laws for earlier taxable years. *Colony, Inc. v. Commissioner*, 357 U.S. 28, 31-32 (1958). This case is worthy of consideration because there are a significant number of affected taxpayers.

This case concerns the investment tax credit claimed by the taxpayers for the 1,000 new compressed gas cylinders purchased by them during 1983 and leased to the lessee. At issue is an interpretation of a provision of the Internal Revenue Code, 26 U.S.C. § 46(e)(3), in effect during 1983 which allows a 10 percent investment tax credit to noncorporate lessors of qualified property if the "term" of the lease is less than 50 percent of the "useful life" of the property. The question presented is whether the Court of Appeals for the Tenth Circuit erred in affirming the Tax Court's conclusion that the lease agreement involved had an indefinite term encompassing at least 50 percent of the useful life of the cylinders, thereby disqualifying the taxpayer from investment credit under the statute.

Under conventional concepts of property law the "term" of the lease is the length of time for which the lessee is granted the right to possess and use the leased property, as determined by reference to the rights and obligations of the parties under the lease agreement. Here, that period is the initial term of 5 years stated in the cylinder rental agreement because there was no right or obligation granted to or imposed upon either party for a period longer than 5 years. The statute itself specifies that options to renew shall be taken into account in determining the "term" of the lease, but this provision has been interpreted to apply only where a party to the lease has an enforceable right to extend or renew the lease. *Ridder v. Commissioner*, 76 T.C. 867, 875 (1981). Unfortunately, there is no other guidance in the statute or the regulations promulgated thereunder as to how the "term" of a lease is to be measured. As a consequence,

there has been considerable litigation on the subject which has produced conflicting results.

Realistic Contemplation Test

The Tax Court decided this case against the taxpayers by applying a subjective standard for determining the term of a lease which has become known as the "realistic contemplation" test. The "realistic contemplation" test was first enunciated by the Tax Court in *Ridder v. Commissioner*, 76 T.C. 867, 875 (1981). The question was whether a noncorporate lessor passed or failed the 50 percent test of 26 U.S.C. § 46(e)(3)(B). The case involved an open-ended lease of a truck which from its inception had no specified lease term but was to continue indefinitely until terminated by either party on 30 day's notice. In the *Ridder* case it was conceded that the taxpayers-lessors retained the financial risk and economic burden of their investment. Nevertheless, the Tax Court held against the taxpayers. Instead of measuring the term of the lease by the period during which the economic risks had been shifted with certainty from the lessor to the lessee, all as determined by the legal rights and obligations of the parties as of the commencement of the lease, the Court applied the subjective "realistic contemplation" test and held that the term of the lease is to be calculated by reference to the realistic expectations of the parties.

In the *Ridder* case the Tax Court described the issue as a close one, but held that since there was no evidence suggesting that the parties realistically contemplated termination within the 50 percent period, the term of the lease was deemed to be indefinite and the taxpayer was

denied the investment tax credit. In the instant case the Tax Court found that the taxpayers failed to show that it was the parties' realistic contemplation to terminate the lease at the expiration of the initial 5-year term.

Regrettably, the decision in the *Ridder* case is not only inconsistent with Congressional intent regarding economic risk, but also the "realistic contemplation" test has failed to achieve the objective of providing ease of administration and predictability. To the contrary, the net result of the "realistic contemplation" test has been confusion, inconsistency, lack of predictability and uncertainty. The government has been on all sides of the issue, depending on the advantage to be gained. *Hoisington v. Commissioner*, 833 F.2d 1398 (10th Cir. 1987) at 1402 (collecting cases).

The *Ridder* case was followed by the decision in *Hokanson v. Commissioner*, 730 F.2d 1245 (9th Cir. 1984) where the U.S. Court of Appeals for the Ninth Circuit agreed that the "realistic contemplation" of the parties is the correct test for calculating the length of a lease term in a case involving a master lease of several trucks having no designated term, but having a right to cancel with respect to any one or more of the units each January on 30 day's notice.

Prior to its review of the Tax Court's decision in this case, the Court of Appeals for the Tenth Circuit adopted the realistic contemplation test in *Schumacher v. U.S.*, 931 F.2d 650 (10th Cir. 1991). Shortly thereafter the Court of Appeals for the Tenth Circuit again approved the "realistic contemplation" test by affirming the Tax Court's decision in this case.

The "realistic contemplation" test has been applied despite express language in the lease limiting the term to something less than 50 percent of the useful life of the property. *Connor v. Commissioner*, 847 F.2d 985 (1st Cir. 1988). Also a modified version of the "realistic contemplation" test, identified as the "reasonable certainty" test, was formulated in *Schiff v. U.S.*, 942 F.2d 348 (6th Cir. 1991).

The essential fairness and validity of the "realistic contemplation" analysis is called into question because its application by the Tax Court (and the approval thereof by each of the Circuit Courts which have approved the Tax Court on this question) is based on the premise that this subjective test may be applied without regard to any shift of economic risk. In most cases, however, the most telling evidence available bearing on the intent of the parties is the extent of their economic commitment to the lease. Does it logically follow that the Tax Court should be permitted to determine the realistic contemplation of the parties without giving consideration to all relevant evidence, including the economic aspects of the transaction?

The Economic Risk Standard

In the process of adopting the "realistic contemplation" test and affirming the Tax Court in this case, the Court of Appeals for the Tenth Circuit considered but rejected the "economic risks and obligations" analysis enunciated by the Court of Appeals for the Seventh Circuit in the case of *McNamara v. Commissioner*, 827 F.2d 168

(7th Cir. 1987). In that case the Seventh Circuit had occasion to interpret 26 U.S.C. § 46(e)(3) in connection with its review of another decision of the Tax Court which held that a taxpayer had failed the 50 percent test of the statute because the parties to the lease realistically contemplated that the leases at issue would extend beyond their stated terms and, therefore, that the actual lease terms were indefinite. The Seventh Circuit reaffirmed its earlier finding in *Freesen v. Commissioner*, 798 F.2d 195, 199 (7th Cir. 1986), regarding the legislative purpose of the statute involved which was to ensure that the lessor bears real economic risk for a substantial portion of the property's useful life. The Court then noted that the Tax Court's application of the "realistic contemplation" test exceeded the Congressional objective behind the 50 percent test of 26 U.S.C. § 46(e)(3)(B). Instead of emphasizing the realistic contemplation of the parties, the Seventh Circuit looked to the shifting of economic risk under the lease agreement as measured by the binding commitment of the lessee. With respect to the lease term specified in the agreement, the Seventh Circuit in *McNamara*, 827 F.2d at 172, stated:

> At least in cases involving leasing activity that is not primarily tax motivated, where the stated lease term in a written lease document satisfies the 50 percent requirement, that document should be respected, and unless the Commissioner can demonstrate that the lease is a 'sham,' *i.e.*, that there has been a real shifting of all economic risk associated with the leased property from the lessor to the lessee, the lessor is entitled to claim an investment tax credit for the property. . . .

The Court in the *McNamara* case further noted that the Tax Court had made no finding that the parties had an expectation that the leases would be renewed on the same or nearly similar terms, and that without some expectation that renewal of the lease would occur on the same terms, it is difficult to understand how the economic risk associated with ownership of the leased property could be shifted from the lessor to the lessee. Rejecting the "realistic contemplation" test, the Seventh Circuit held:

> The parties' realistic contemplation that the lease may extend beyond the stated term is insufficient to achieve such risk-shifting, . . . [A]t minimum there must be a fixed intention that the lease will be continuously renewed on the same or substantively identical terms. (*Id.* at 172)

In this case of taxpayer Hauptli, the written provisions of the cylinder rental agreement show that it was not the intent to continue the lease on the same terms and conditions. The parties committed only to an initial term of 5 years, and it was agreed from the beginning that the 5-year commitment would end at the conclusion of the initial term. Neither party had an absolute right or option to renew the lease and the lease provided for continuation only on a year-to-year basis – a significantly different economic commitment. Viewed from any perspective, there was no definite shift of economic risk to the lessee in the instant case beyond the specified initial term of 5 years. That is the crux of the holding in the *McNamara* case which the Court of Appeals for the Tenth Circuit declined to apply in *Schumacher v. U.S.*, 931 F.2d at 654,

and again in *Hauptli v. Commissioner*, 951 F.2d 1193, 1196 (10th Cir. 1991).

A genuine conflict exists between the economic risk standard of the Seventh Circuit as enunciated in the *Freesen* and *McNamara* cases and the realistic contemplation test adopted by the Tenth Circuit and other circuits. It is a clear conflict between circuits in interpreting the Internal Revenue Code so that the tax code is being administered differently in different parts of the Country. This Court should grant *certiorari* to resolve the conflicting interpretations of the tax statute involved so that the tax law may be administered uniformly over the United States. *Colony, Inc. v. Commissioner*, 357 U.S. 28, 31-32 (1958).

This case is identical in all material respects to the related case of *Russell v. Commissioner*, T.C. Memo 1991-269, reported at 61 T.C.M. (CCH) 2909 (1991) and reprinted in its entirety as Appendix G. In the *Russell* case the Tax Court concluded that the economic risk rule of the *McNamara* case does not apply because the provisions of the leases are materially different. Based on this premise, the Tax Court then reasoned that it was free to apply the "realistic contemplation" analysis in the *Russell* case, without regard to any shift of economic risk. The *Russell* case presently is on appeal to the United States Court of Appeals for the Seventh Circuit. The case has been fully briefed and argued and is awaiting the decision of the Court of Appeals. Since a virtually identical record is involved, a reversal of the Tax Court on this issue would constitute a square conflict with this case.

Burden of Proof

There is a subsidiary question that is fairly included in the primary question presented above. That subsidiary question concerns the taxpayer's burden of proof.

The case of *Schiff v. U.S.*, 942 F.2d 348 (6th Cir. 1991), supports the taxpayers' position that the reasonable certainty test is an acceptable method of discharging the taxpayer's burden to show the realistic contemplation of the parties. In *Schiff* at 351, the Court formulated the question as follows:

> Thus, the realistic contemplation test places the initial burden on the taxpayer who must show that, at the time of the lease's execution, *there was not a reasonable certainty* that the lessee would continue leasing the property beyond the period stated in the lease.

(Emphasis added)

Is the foregoing a fair and accurate recitation of the taxpayers' burden of proof in this matter? Not according to the Court of Appeals for the Tenth Circuit who disapproved the "reasonable certainty" method of proof in *Hauptli v. Commissioner,* 951 F.2d at 1195, as follows:

> Taxpayers argue that they should prevail if they can show that 'it [was not] reasonably certain that the lessee [would] continue leasing the property beyond the initial term fixed in the lease.' . . . This test turns the statutory scheme on its head. The statute provides that a taxpayer will earn a credit if 'the term of the lease . . . is less than 50 percent of the useful life of the property.' 26 U.S.C. § 46(e)(3)(B). The taxpayer

> meets his or her burden of demonstrating entitlement to the credit by proving that the term of the lease was less than fifty percent, not by proving that it was *not* reasonably certain that the term would be *more* than fifty percent.

(Emphasis in original)

Further, in disapproving the rationale of the *McNamara* case the Tenth Circuit did so in *Hauptli v. Commissioner*, 951 F.2d at 1196, as follows:

> Taxpayers finally argue that only if there was a fixed intention to continue the lease on the same or substantively identical terms could the lease be considered indefinite for tax purposes. . . . As authority for this proposition, taxpayers cite *McNamara*, 827 F.2d at 172. As discussed above, however, we think focusing the inquiry on an intention to continue beyond the fifty percent useful life misinterprets the statute. The statute requires taxpayers to make the affirmative showing that the life of the lease was less than fifty percent of the useful life of the property and not the negative of that fact.

Similarly, in *Schiff v. U.S.*, 942 F.2d at 352, the majority opinion stated:

> The *McNamara* rule is also inappropriate because it shifts the burden of proof to the government whenever parties, even if they are not dealing at arm's length, have executed a mechanically perfect lease. Requiring the government to prove that a lease is sham, before the taxpayer has made any meaningful showing that the lease is to last no longer than 50 percent of the leased property's useful life, ignores the thrust of Rule 142(a), Tax Court Rules of Practice

> and Procedure, 26 U.S.C. foll. § 7453 (taxpayer bears burden of proof in protesting deficiency assessed by Commissioner).

The dissenting opinion in *Schiff* at 354 disagreed with the majority "for the reasons articulated in the well-reasoned opinion of the Seventh Circuit in *McNamara v. Commissioner*, 827 F.2d 168 (7th Cir. 1987)."

Undoubtedly, a taxpayer always retains the ultimate burden of proof, but there should be some point where the burden of rebutting a *prima facie* case shifts to the Commissioner of Internal Revenue. The often cited case of *Welch v. Helvering*, 290 U.S. 111 (1933) clearly established that the burden of proof is on the taxpayer. However, the nature and extent of that burden of proof is not as crystal clear as the principle itself. A clarification of the meaning and extent of the taxpayer's burden of proof is long overdue.

This question has caused the Tax Court much consternation and in the recent case of *Borchers v. Commissioner*, 95 T.C. 82 (1990), the Tax Court on reconsideration of its original decision reversed itself on this precise question of when and to what extent a taxpayer has carried his burden of proof. The *Borchers* case concerned the very statute involved in this case and was relied upon by the Tax Court to decide against the taxpayers here. Viewed from a broader perspective, this is an issue which has great impact nationwide and should justify the granting of *certiorari* on its own merits.

CONCLUSION

For the foregoing reasons, this petition for a writ of *certiorari* should be granted.

Respectfully submitted,

THOMAS J. KENNEDY
KENNEDY BERKLEY YARNEVICH
& WILLIAMSON, CHARTERED

710 United Building
Salina, KS 67401
(913) 825-4674

Counsel for Petitioners

April 13, 1992

APPENDIX A

PUBLISH

UNITED STATES COURT OF APPEALS

FOR THE TENTH CIRCUIT

AUGUST J. HAUPTLI, JR., and BARBARA HAUPTLI, Petitioners-Appellants,	)	No. 91-9006
v.	)	
COMMISSIONER OF INTERNAL REVENUE, Respondent-Appellee.	)	(Filed Dec. 19, 1991)

APPEAL FROM THE UNITED STATES TAX COURT
(T.C. No. 8254-87)

Thomas J. Kennedy, Kennedy Berkley Yarnevich & Williamson, Chartered, Salina, Kansas, for Petitioners-Appellants.

Shirley D. Peterson, Assistant Attorney General Tax Division, Department of Justice, Washington, D.C. (Gary R. Allen, Jonathan S. Cohen and Joel A. Rabinovitz with her on the brief), for Respondent-Appellee.

Before ANDERSON, TACHA and BRORBY, Circuit Judges.

BRORBY, Circuit Judge.

The issue in this case is whether taxpayers, August J. Hauptli, Jr., and Barbara Hauptli, noncorporate lessors of personal property, are entitled to an investment tax credit because their lease of compressed gas cylinders was for a term of less than fifty percent of the useful life of the cylinders as required for the credit by section 46(e)(3)(B) of the Internal Revenue Code.[1] Because we agree with the tax court that taxpayers have failed to prove that at the time the lease was executed the parties realistically contemplated that the term of the lease would be less than fifty percent of the useful life of the cylinders, we affirm.[2]

In 1983 taxpayers claimed an investment tax credit of $14,135 under section 46(e)(3)(B)[3] then in effect. The

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[1] Unless otherwise noted, all statutory references are to the Internal Revenue Code of 1954, as amended and in effect during the years here in issue.

[2] After examining the briefs and appellate record, this panel has determined unanimously that oral argument would not materially assist the determination of this appeal. *See* Fed. R. App. P. 34(a); 10th Cir. R. 34.1.9. The case is therefore ordered submitted without oral argument.

[3] Section 46(e)(3)(B) provided that:

> (3) NONCORPORATE LESSORS. – A credit shall be allowed by section 38 to a person which is not a corporation with respect to property of which such person is the lessor only if –
>
> . . . .
>
> (B) the term of the lease (taking into account options to renew) is less than 50 percent of the useful life of the property, and for the period consisting of the first 12 months after the date on which the property is transferred to the lessee the sum of the deductions

(Continued on following page)

credit was claimed pursuant to a lease of one thousand gas cylinders between taxpayers and an unrelated entity.[4] Taxpayers and the Commissioner agree that the useful life of the cylinders is thirty-five years. The lease provided for a stated initial term of five years, cancellable thereafter upon twelve months' written notice from either party. The sole issue in this case is whether this lease was for a term less than fifty percent of the useful life of the cylinders or was in fact a lease for an indefinite term.

Whether the term of the lease is for less than fifty percent of the useful life of the property is a question of fact which we review for clear error. *Shumacher v. United States*, 931 F.2d 650, 652 (10th Cir. 1991).

> If the district court's account of the evidence is plausible in light of the record viewed in its entirety, the court of appeals may not reverse it even though convinced that had it been sitting as the trier of fact, it would have weighed the evidence differently. Where there are two permissible views of the evidence, the factfinder's choice between them cannot be clearly erroneous.

Id. (citation omitted).

(Continued from previous page)

> with respect to such property which are allowable to the lessor solely by reason of section 162 (other than rents and reimbursed amounts with respect to such property) exceeds 15 percent of the rental income produced by such property.

[4] In *Hauptli v. Comm'r*, 902 F.2d 1505, 1507 (10th Cir. 1990), we held that the Tax Court had erred in failing to look to the ultimate end users of the cylinders to establish the class life of the property for purposes of the investment tax credit.

It is a long established tenet of tax law that tax credits are matters of legislative grace, and the burden is on taxpayers to demonstrate clearly that they are entitled to the credit. *Id.* The crux of this case is how to formulate the standard which taxpayers are required to meet.

The majority of courts which have considered this issue have required the taxpayer to show that at the beginning of the lease the parties "realistically contemplated" that the lease would be for less than fifty percent of the useful life of the property. This showing has been required despite express language in the lease limiting the term to something less than the fifty percent useful life. *Schiff v. United States*, 942 F.2d 348, 351-54 (6th Cir. 1991) (disregarding lease with stated two year term); *Borchers v. Comm'r*, 943 F.2d 22, 23 (8th Cir. 1991) (disregarding lease with one year stated term); *Connor v. Comm'r*, 847 F.2d 985, 989 (1st Cir. 1988) (same); *Hokanson v. Comm'r*, 730 F.2d 1245, 1248 (9th Cir. 1984) (disregarding lease with an implied one year term); *see also Schumacher*, 931 F.2d at 653 (adopting realistic contemplation test for verbal leases without termination dates). "[A] minimum duration specified in a lease is not the controlling factor in determining the length of the term of the lease for section 38 purposes." *Hokanson*, 730 F.2d at 1249 n.2.

Taxpayers, however, would have us recognize a test they describe as the "reasonable certainty" test which they alternately characterize as either a separate test, *see* Appellants' Opening Brief at 22-27, or as a means of proving their realistic contemplation, *see* Appellants' Reply Brief at 7-9. We decline to follow either suggestion.

Under either test when properly phrased, taxpayers have failed to sustain their burden.

Taxpayers argue that they should prevail if they can show that "it [was not] reasonably certain that the lessee [would] continue leasing the property beyond the initial term fixed in the lease." Appellants' Opening Brief at 28. This test turns the statutory scheme on its head. The statute provides that a taxpayer will earn a credit if "the term of the lease . . . is less than 50 percent of the useful life of the property." 26 U.S.C. § 46(e)(3)(B). The taxpayer meets his or her burden of demonstrating entitlement to the credit by proving that the term of the lease was less than fifty percent, not by proving that it was *not* reasonably certain that the term would be *more* than fifty percent. This circuit has adopted the language of *McNamara v. Comm'r*, 827 F.2d 168 (7th Cir. 1987), requiring a "*fixed* intention" with respect to the lease term. *Hoisington v. Comm'r*, 833 F.2d 1398, 1404 (10th Cir. 1987).[5]

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[5] In *Schiff v. Comm'r*, 942 F.2d 348 (6th Cir. 1991), the Sixth Circuit endorsed the realistic contemplation test, *id.* at 353, but formulated the test as "a showing that the parties to the lease at the time of execution realistically contemplated that the lease's term would not extend beyond 50 percent of the leased property's useful life," *id.*, and alternatively, as a showing that "at the time of the lease's execution, there was not a reasonable certainty that the lessee would continue leasing the property beyond the period stated in the lease." *Id.* at 351. To the extent that these formulations are inconsistent, we subscribe to the former phraseology only. Language in *Sauey v. Comm'r*, 90 T.C. 824, 829 (1988), *aff'd without opinion*, 881 F.2d 1086 (11th Cir. 1989), and *Peterson v. Comm'r*, 44 T.C.M. (CCH) 674, 679 (1982), indicating that the proper test is whether there is a reasonable certainty that the lease will continue beyond the fifty percent useful life mark is similarly disapproved.

Taxpayers argue, and our review of the record confirms, that the evidence shows unequivocally that the parties had no idea at the time they entered into the lease what course would be elected at the end of the five year initial term. Taxpayers maintain, therefore, that there was no "reasonable certainty" that the lease would extend beyond fifty percent of the useful life of the cylinders and that they are therefore entitled to the credit. This argument and the evidence supporting it, however, seals taxpayers' fate.

Taxpayers were required to show that at the beginning of the leasing arrangement the parties had a fixed intention to terminate the lease before fifty percent of the useful life of the cylinders had expired. *Schumacher,* 931 F.2d at 653 (citing *Hoisington,* 833 F.2d at 1404-05). Their evidence, however, is to the contrary. Neither party had any "realistic contemplation" or "fixed intention" regarding how long the lease would run. Taxpayers have thus failed to sustain their burden.

Taxpayers make two additional points that deserve our attention. They argue that a distinguishing factor in this case is that this lease was "between unrelated parties who dealt at arm's length" and that in nearly every case denying an investment tax credit under circumstances similar to these "there has been an element of common control or other close relationship between the lessor and the lessee which strongly indicated the lease would be continued indefinitely." Appellants' Opening Brief at 34. While this is generally true, we are not prepared to add a gloss to the statute implying any presumption on the part of nonrelated parties. While admittedly a factor in determining the realistic contemplation of the parties, common

control, by itself, is not determinative. *Sanders v. Comm'r*, 48 T.C.M. (CCH) 1215, 1221 (1984); *Peterson v. Comm'r*, 44 T.C.M. (CCH) 674, 678-79 & n.8 (1982); *cf. Sauey v. Comm'r*, 90 T.C. 824 (1988) (fact that two entities are related cannot be the sole basis for denying investment tax credit).

Taxpayers finally argue that only if there was a fixed intention to continue the lease on the same or substantively identical terms could the lease be considered indefinite for tax purposes. Appellants' Reply Brief at 5. As authority for this proposition, taxpayers cite *McNamara*, 827 F.2d at 172. As discussed above, however, we think focusing the inquiry on an intention to continue beyond the fifty percent useful life misinterprets the statute. The statute requires taxpayers to make the affirmative showing that the life of the lease was less than fifty percent of the useful life of the property and not the negative of that fact. In conclusion, after review of this record we find no clear error in the tax court's conclusion regarding the indefinite nature of this lease. The judgment of the tax court is, therefore, AFFIRMED.

APPENDIX B

UNITED STATES COURT OF APPEALS
FOR THE TENTH CIRCUIT

AUGUST J. HAUPTLI, JR.; BARBARA HAUPTLI, Petitioners-Appellants,	)	
v.	)	No. 91-9006
COMMISSIONER OF INTERNAL REVENUE, Respondent-Appellee.	)	

ORDER

January 21, 1992

Before ANDERSON, TACHA and BRORBY, Circuit Judges.

This matter comes on for consideration of appellants' petition for rehearing.

Upon consideration whereof, the petition for rehearing is denied.

Entered for the Court
ROBERT L. HOECKER, Clerk

By: /s/ Patrick Fisher
Patrick Fisher
Chief Deputy Clerk

APPENDIX C

T.C. Memo. 1991-72

UNITED STATES TAX COURT

AUGUST J. HAUPTLI, JR., AND BARBARA HAUPTLI, Petitioners *v.* COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 8254-87. Filed February 26, 1991.

Held: (On remand.) The term of the lease of gas cylinders by petitioners was indefinite, and thus for purposes of section 46(e)(3)(B), the term is not "less than 50 percent of the useful life of the property."

Thomas J. Kennedy, for the petitioners.

Osmun R. Latrobe, for the respondent.

SUPPLEMENTAL MEMORANDUM OPINION

WHITAKER, *Judge*: In *Hauptli v. Commissioner,* T.C. Memo. 1988-518, and incorporated herein by this reference, we determined that the compressed gas cylinders used by petitioner in his cylinder-leasing business were governed by Rev. Proc. 83-35, 1983-1 C.B. 745, and belonged in Asset Guideline Class 57.0, which applies in general to wholesale and retail trades. We interpreted the regulations to require us to focus on A & R Welding Supply Corp. (A & R), the lessee of petitioner and the lessor of the end-users of the cylinders, with the result that we determined the useful life of the cylinders to be 9 years. As a result, we concluded that the term of the

5-year lease exceeded the limitation of section 46(e)(3)(B)[1] in that the term is more than 50 percent of the 9-year life.

On appeal in a judgment entered on May 8, 1990,[2] the Court of Appeals for the Tenth Circuit reversed and remanded the case for further proceedings. The Court of Appeals held that we should have looked to A & R's lessees to establish the class life of the cylinders. We were directed to determine the business activity of the end-user lessees if possible. If that is not possible, we are directed to determine the class life in accordance with the procedures described in Rev. Proc. 86-36, 1986-2 C.B. 596. The Court of Appeals also gave us the option of deciding this case on the basis of respondent's alternate contention that the term of the lease between the taxpayers and A & R was in excess of the original 5-year period by virtue of the automatic 1-year renewal built into the agreement.

With regard to the first instruction of the Court of Appeals, the parties have stipulated for purposes of our present consideration that from a practical standpoint "it is not feasible on remand to determine the class life, if any, which would be applicable to the gas cylinders involved in this case." Thus, we are required either to apply Rev. Proc. 86-36 or to reach respondent's alternate contention. We will address the latter.

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[1] Unless otherwise noted, all section references are to the Internal Revenue Code of 1954 as amended and in effect for the year in issue.

[2] The appellate court opinion is reported at *Hauptli v. Commissioner*, 902 F.2d 1505 (10th Cir. 1990).

Section 46(e)(3)(B) in pertinent part provides that a noncorporate lessor is allowed an investment tax credit only if "the term of the lease (taking into account options to renew) is less than 50 percent of the useful life of the property." Respondent both in his original brief and in his supplemental brief on remand argues forcefully that the term of the lease was "open-ended" and that the parties had "no realistic contemplation of or expectation that a termination would take place." Therefore, he contends, the 50-percent test has not been met.

The lease between A & R and petitioner provided that after the initial term the lease would continue from year to year until terminated by not less than 12 months' prior written notice. We found in our prior opinion that, on the date of the agreement, "there was no understanding or agreement between the parties to the lease as to whether the lease would be allowed to continue in effect or be terminated at the end of the 5-year initial term. Neither was there any understanding or agreement as to whether the cylinders would be purchased pursuant to the purchase option." *Hauptli v. Commissioner*, T.C. Memo. 1988-518, 56 T.C.M. 583, 585, 57 P-H Memo T.C. par. 88,518, at 2649. These findings were not disturbed by the Court of Appeals.

On the issue as to the term of the lease, our facts are very similar to those in *Ridder v. Commissioner*, 76 T.C. 867 (1981), which involved the lease of a tractor truck. The lease in *Ridder* provided that it would end " 'Upon thirty (30) days written notice by either party, or upon mutual consent of both parties on or after July 3, 1975.' " 76 T.C. at 870. We found that the duration of the term was indefinite. The lease was in effect "self-extending."

Respondent also calls to our attention three recent cases which he deems pertinent, *Owen v. Commissioner,* 881 F.2d 832 (9th Cir. 1989), affg. T.C. Memo. 1987-375; *Connor v. Commissioner,* 847 F.2d 985 (1st Cir. 1988), affg. T.C. Memo. 1987-223; and our recent opinion in *Borchers v. Commissioner,* 95 T.C. 82 (1990). These three cases are distinguishable upon their facts since in each case the lessee and the lessor were related. In *Borchers,* however, which relies on both *Owen* and *Connor,* we provided a standard which is applicable here.

> In deciding whether a lease is of indefinite duration or limited to the definite term specified in the lease, all the facts and circumstances are considered. The duration of the lease is decided based on the " 'realistic contemplation' of the parties at the time the lease was entered into." Consequently, if it appears that the substance of the transaction is that the lessee will continue leasing the property beyond the period stated in the lease, then the specified lease term is disregarded and the lease is considered to be of indefinite length. [*Borchers v. Commissioner,* 95 T.C. at 88; citations omitted.]

Applying the test of *Borchers* to the facts in this case we to [sic] conclude that the lease here was for an indefinite term. The parties herein have stipulated that the gas cylinders "have a physical life of over 35 years unless lost or unusually damaged." It is, however, obvious that a lease with an indefinite term has a term in excess of 50 percent of the useful life of the property, which in this case is 17-1/2 years.

On this basis, therefore, we conclude that the gas cylinders in issue here do not qualify for the investment

tax credit by reason of the fact that they do not meet the first requirement of section 46(e)(3)(B).

Decision will be entered for the respondent.

APPENDIX D

UNITED STATES TAX COURT
WASHINGTON, D.C. 20217

AUGUST J. HAUPTLI, JR., AND BARBARA HAUPTLI,	)	
Petitioners,	)	Docket
v.	)	No. 8254-87
COMMISSIONER OF INTERNAL REVENUE,	)	
Respondent.	)	

DECISION

Pursuant to the determination of this Court as set forth in its Supplemental Memorandum Opinion (T.C. Memo. 1991-72) filed February 26, 1991, it is

ORDERED AND DECIDED that there is a deficiency in the Federal income tax liability of petitioners for the calendar year 1983 in the amount of $13,668.

/s/ Meade Whitaker
Meade Whitaker
Judge

Entered: MAR 6 1991

APPENDIX E

PUBLISH

UNITED STATES COURT OF APPEALS

TENTH CIRCUIT

AUGUST J. HAUPTLI, JR. and BARBARA HAUPTLI, Petitioners-Appellants, v. COMMISSIONER OF INTERNAL REVENUE, Respondent-Appellee.	)	No. 89-9001 (FILED MAY 8 1990)

APPEAL FROM THE UNITED STATES TAX COURT
DOCKET NO. 8254-87

Thomas J. Kennedy, Kennedy Berkley Yarnevich & Williamson, Salina, Kansas, Attorney for Petitioners-Appellants.

Joel A. Rabinovitz, Attorney, Tax Division, Department of Justice, Washington, D.C. (James I. K. Knapp, Acting Assistant Attorney General, Gary R. Allen and Jonathan S. Cohen, Attorneys Tax Division, Department of Justice, Washington, D.C., with him on the brief), Attorneys for Respondent-Appellee.

Before ANDERSON and BRORBY, Circuit Judges, and

THEIS,* District Judge.

ANDERSON, Circuit Judge.

Taxpayers, August J. and Barbara Hauptli, appeal a decision of the United States Tax Court sustaining an income tax deficiency for the calendar year 1983 in the amount of $13,668. The Tax Court held that the taxpayers improperly claimed an investment credit for compressed gas storage cylinders which they had purchased and leased to a welding supply company. *Hauptli v. Commissioner,* 56 T.C.M. (CCH) 583 (1988). The sole issue on appeal is whether the Tax Court correctly concluded that the term of the lease agreement exceeded 50% of the cylinders' useful life, thus disqualifying Hauptli from any investment credit. 26 U.S.C. § 46(e)(3).[1] Because the Tax Court incorrectly determined the useful life of the cylinders, we reverse and remand for further proceedings.

BACKGROUND

In 1983, the taxpayers purchased 1,000 compressed gas cylinders, used to store various gases such as oxygen,

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* The Honorable Frank G. Theis, Senior Judge, United States District Court for the District of Kansas, sitting by designation.

[1] 26 U.S.C. § 46(e)(3) provides, in part:

> "A credit shall be allowed . . . to a person which is not a corporation with respect to property of which such person is the lessor only if – (B) the term of the lease (taking into account options to renew) is less than 50 percent of the useful life of the property."

acetylene, argon, nitrogen, carbon dioxide, and helium. Once stored in these cylinders, the gases have a wide range of applications in numerous industries and in medical offices and hospitals. The gas cylinders are extremely durable and generally have a physical life exceeding thirty-five years. Stipulation of Facts, R. Vol. I at Tab 7, p.4.

The taxpayers leased the cylinders for an initial term of five years to A&R Welding Supply Co. ("A&R"). In turn, A&R rented the cylinders "on a monthly basis to A&R Welding's customers to contain the gases which [the customers] purchased [from A&R]." Stipulation of Facts, R. Vol. I at Tab 7, p.3. The cylinders were all placed in service in 1983.

The taxpayers claimed an investment tax credit based on the purchase price of the cylinders against their income tax for the calendar year 1983. The Commissioner disallowed the credit, explaining in the Notice of Deficiency that they had "not established that this credit is computed on any amount which qualifies under the provisions of the Internal Revenue Code for investment tax credit." R. Vol. I at Tab 2, Exhibit A p.3. The taxpayers then petitioned the Tax Court for relief.

The Tax Court agreed with the Commissioner that the taxpayers were not entitled to the investment credit because the term of the lease with A&R was for more than one-half of the useful life of the property. In concluding that taxpayers were ineligible for the tax credit, the Tax Court applied a "useful life" of nine years for purposes of testing whether the term of the lease agreement exceeded 50% of the cylinders' useful life under

§ 46(e)(3)(B). On appeal taxpayers challenge the imposition of a nine year useful life, contending that there is no support in the law or regulations for a period that short. The relevant facts involved are undisputed; we review the Tax Court's legal conclusions *de novo. Miller v. Commissioner,* 836 F.2d 1274, 1277 (10th Cir. 1988).

DISCUSSION

In general, the "useful life" of the cylinders, for the purposes of testing the taxpayers' eligibility for the investment tax credit, is "the class life prescribed by the Secretary which reasonably reflects the anticipated useful life of property to the industry or other group." 26 U.S.C. § 167(m)(1) (as referenced in § 168(i)(1)(A) (defining "class life" as used in § 168(g)(2) which is referenced in turn by § 46(e)(3)(B))). Revenue Procedure 83-35, 1983-1 C.B. 745 (1983) establishes asset guideline classes applicable for the year 1983, and sets the life for each guideline class. It is undisputed that none of the specific class lives established by the secretary relates to cylinders or to the business activity of renting cylinders. In such instances Treas. Reg. § 1.167(a)-11(e)(3)(iii), provides that "the asset guideline class for such property shall be determined as if the property were owned by the lessee." Accordingly, the Tax Court looked to A&R, the taxpayers' lessee. The court reasoned that A&R was primarily engaged in wholesale and retail trade and sales of compressed gases and welding supplies. Therefore, the court applied asset guideline class 57.0 which includes assets used in "Distributive Trades and Services" to compute a nine year class life for the cylinders. *See* Rev. Proc. 83-35, 1983-1 C.B. 745, 762. It is on this point that we diverge from the Tax Court.

While A&R's primary business is as described by the Tax Court, A&R is also a lessor of the cylinders, on a sublease basis, to its customers. The parties stipulated and the Tax Court found that A&R rented tanks on a monthly basis, deriving substantial separate income from that activity. The revenue from the monthly rental of cylinders represented approximately 17% of A&R's gross revenue – more than one-half of the revenue generated by the actual sale of compressed gas. Stipulation of Facts, R. Vol. I at Tab 7, p.3. Rental income was separately accounted for on A&R's books. The rental terms apparently were set out in written agreements between A&R and its customer-lessees.

Since A&R was a lessor of the cylinders then, just as in the case of the taxpayer-lessors, no guideline class applied, and the Tax Court was obligated to look past A&R to the activities of *its* lessees for a guideline life, as prescribed by Treas. Reg. § 1.167(a)-11(e)(3)(iii). The Tax Court attempts to avoid that result by reasoning that the cylinders were "used" by A&R in its distribution business. That is, providing tanks to customers facilitated the sale of compressed gases, and was only an incidental (though necessary) component of the gas sales. In other words, the Tax Court erected a primary business test to determine if a person is a lessor. No such test is discernible on the face of the governing regulation, which provides:

> "*In the case of a lessor of property,* unless there is an asset guideline class in effect for *lessors of such property,* the asset guideline class for such property shall be determined as if the property were owned by the lessee. However, in the case

> of an asset guideline class based upon the type of property . . . as distinguished from the activity in which used, the property shall be classified without regard to the activity of the lessee."

Treas. Reg. § 1.167(a)-11(e)(3)(iii) (emphasis added). The Tax Court cites no authority for its restrictive definition of the term "lessor of property" in the regulation, and we decline to adopt it on the basis of the record in this case.[2]

Furthermore, the basic logic involved in setting class lives for leased assets also suggests that we should look to the activities of the end user lessees of these tanks. As a practical matter it is that final "use," not the filling and delivery of the tanks by A&R which will eventually determine the physical and economic life of these cylinders. The frequency with which the tanks are filled and the physical conditions under which they must perform depend on the nature of the end users' activities, not A&R's operations.

Accordingly, we hold that the Tax Court erred in looking to A&R to establish a class life for these cylinders. It was required to look to A&R's lessees.

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[2] The Tax Court interpreted "the word 'lessee' in [§ 1.167(a)-11(e)(3)(iii)] to refer to the entity which is actually using the cylinders in its gas distribution business which is A&R . . . " rather than the ultimate consumer of the gas. R. Vol. I at Tab 10, p.13. This reasoning is unpersuasive. Insofar as the cylinders are essential to the operation involved, both A&R and the ultimate consumers are "using" the cylinders for gas storage. However, inasmuch as the actual physical wear and tear on the cylinders is concerned, the majority of the cylinders' "use" will be in the hands of the consumers, not A&R.

The Tax Court made no findings of fact concerning the business activity of the end user lessees of these gas cylinders. If it is impossible on remand to determine a class life, either because the activities of the end users cannot be ascertained, or because no appropriate asset guideline class exists for the broad and differing spectrum of activities in which the tanks are used, then the useful life of the cylinders could still be determined in accordance with the procedure described in Rev. Proc. 86-36, 1986-2 C.B. 596. That procedure applies solely for the purpose of determining the maximum term of a lease permissible for investment tax credit purposes where there is no applicable class life prescribed for the asset involved. In those situations, the estimated useful life of the property should be determined in accordance with traditional rules of estimating actual useful life in the trade or business. *See id.* Whatever class life or other useful life the Tax Court ultimately uses, the statute clearly provides that the time period must "reasonably reflect . . . the anticipated useful life of [the] property to the industry. . . . " 26 U.S.C. § 167(m)(1).

The Tax Court did not reach the Commissioner's alternate contention below that the term of the lease between the taxpayers and A&R was in excess of the original five year period by virtue of the automatic one-year renewal built into the agreement. That issue is also open for consideration on remand.

CONCLUSION

The memorandum opinion of the Tax Court is REVERSED and the case is REMANDED for further proceedings consistent herewith.

APPENDIX F

T. C. Memo. 1988-518

UNITED STATES TAX COURT

AUGUST J. HAUPTLI, JR., AND BARBARA HAUPTLI, Petitioners *v.* COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 8254-87. Filed November 7, 1988.

Petitioners purchased compressed gas cylinders for lease to a welding business. In order to determine whether the term of the lease is less than 50 percent of the useful life of the property for purposes of section 46(e)(3), we look to the applicable class life in the Asset Depreciation Range System. *Held:* Class life 57.0 applicable to Distributive Trades and Services applies to the lessee welding business, which is the business activity to be considered pursuant to section 1.167(a)-11(e)(3)(iii), Income Tax Regs.

Thomas J. Kennedy, for the petitioners.

Osmun R. Latrobe, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

WHITAKER, *Judge*: Respondent determined a deficiency in the Federal income tax liability of petitioners for the calendar year 1983 in the amount of $13,668. The issue for decision is whether petitioners are entitled to investment credit under section 46(e)(3)(B)[1] for the purchase

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[1] All section references are to the Internal Revenue Code of 1954, as amended and in effect during the years in issue, and

(Continued on following page)

during 1983 of 1,000 compressed gas cylinders for lease to a [sic] unrelated party. More specifically the issue is whether the term of the lease is less than one-half of the useful life of the property.

FINDINGS OF FACT

Some of the facts have been stipulated and they are so found. At the time of the filing of the petition, petitioners, who are husband and wife, were residents of Salina, Kansas. Petitioners' 1983 Federal income tax return was filed on a cash receipts and disbursement basis.

Brown Welding Supply, Inc., is a Kansas corporation and at least at the time of trial was a subsidiary of Brown Industries. It or its parent has for many years been engaged in the gas supply business. Gas cylinders of the type involved in this business are used as the container for the storage under pressure of various gases used in various industries and in medical offices and hospitals. Typical of these gases are oxygen, acetylene, argon, nitrogen, carbon dioxide, and helium and various mixtures thereof. Brown Welding or its parent (collectively referred to as Brown Welding) were, during 1983 and for a number of years prior thereto, engaged both in the sale and distribution of these gases and in the wholesale rental of gas cylinders to other suppliers of gases. Typically, the gas supplier or distributor sells the gas in the

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(Continued from previous page)

all Rule references are to the Tax Court Rules of Practice and Procedure.

cylinder to a customer and rents the cylinder to the customer as a container for the gas until empty. The cylinder is then supposed to be returned to the supplier.

Gas cylinders are composed of the cylinder itself, a collar, a cap, and a valve. The collar and cap are needed in order to protect the valve from damage during shipping and handling of the cylinder. The cylinders are almost indestructible having a useful life of more than 35 years. The collar and cap are subject to breakage and the valve may be broken or become worn out. However, these items may be replaced for a relatively small cost. The collar serves the dual function of holding the cap in place and identifying the owner of the cylinder or the lessee, either of which may be the gas distributor or gas supplier. This has significance in part because of the custom or law which prohibits any gas supplier or distributor from filling a gas cylinder which does not have that particular person's name on the cylinder collar. It is advantageous to the supplier of gas to the end user to have that supplier's name engraved on the collar in that there is then an incentive on the part of the consumer of the gas to return the cylinder to that particular supplier for refilling.

Most of these gases are manufactured and supplied by a small number of manufacturers, one of which is Union Carbide Corporation or one of its subsidiaries (collectively Union Carbide). During this period of time, it was the practice of Union Carbide to cause its name to be placed on collars of gas cylinders which it leased to gas suppliers to whom it wholesaled various gases. This practice prevented the retail supplier of gas from exercising maximum control over the gas cylinders so obtained.

it permitted the ultimate user to return the cylinder to any retail supplier who purchased gas from Union Carbide. Union Carbide leased the cylinders to gas suppliers on a daily rental basis, permitting the supplier to return excess cylinders at any time. A similar rental arrangement of the cylinders normally existed between the supplier of gas and the consumer.

Brown Welding conceived of the idea of purchasing gas cylinders from the cylinder manufacturers and renting those cylinders to other gas suppliers. One of the inducements offered was the placing of the name of the lessee-gas supplier on the collar. Because Brown Welding saw a larger market for the rental of gas cylinders to other gas suppliers than could be met by the number of cylinders which its financial structure permitted it to purchase for its own account, it set up a program by which individuals such as Mr. Hauptli could purchase gas cylinders from manufacturers and enter into agreements with Brown Welding for management of the leasing of the cylinders.

During 1982 and 1983 Brown Welding entered into several arrangements with investors including petitioners pursuant to which 5,000 of these cylinders were leased to A & R Welding Supply Corp. (A & R) for use by A & R in its gas distribution business. Through Brown Welding Mr. Hauptli purchased from Chesterfield Cylinder Co., Inc. (Chesterfield) 1,000 of these cylinders for lease to A & R. During 1983 A & R had thousands of cylinders under lease from Union Carbide. A & R was able to return to Union Carbide a number of cylinders equivalent to the number rented through Brown Welding. Approximately 48 percent of A & R's revenue was derived from sale of

equipment and supplies, approximately 31 percent from sale of gases, approximately 17 percent from cylinder rental, and the remaining 4 percent from delivery charges and other revenue.

In order to induce A & R to enter into cylinder rental agreements, Brown Welding fixed the rental at an amount equal to 70 percent of the then current rental being paid to Union Carbide. The other advantages of this rental arrangement were that the cylinders were all new and thus would not require testing for a minimum of 10 years, their valves were better than the Union Carbide valves, A & R's name was placed on the collar, and the leases had purchase options. The reduced rental rate reflected in part the fact that the cylinders were leased for a fixed term of 5 years as contrasted with the daily rental rate charged by Union Carbide.

The lease term between Mr. Hauptli and A & R, as originally proposed by Brown Welding, was 7 years, with a specified monthly rental, subject to an annual cost-of-living adjustment commencing on January 1, 1985. After the initial term the lease continued from year to year until terminated by not less than 12-months prior written notice. A & R as lessee had the right to purchase any or all of the cylinders at specified prices. The only material change from the first proposal by Brown Welding was reduction of the initial term to 5 years and a small reduction in the specified option purchase price. These changes were made in part to conform the Hauptli rental arrangement to the rental agreements already executed covering the other 4,000 cylinders leased to A & R by other investors.

On October 21, 1983, the date of the agreement between Mr. Hauptli and A & R, there was no understanding or agreement between the parties to the lease as to whether the lease would be allowed to continue in effect or would be terminated at the end of the 5-year initial term. Neither was there any understanding or agreement as to whether the cylinders would be purchased pursuant to the purchase option. It was A & R's intent at that time to maintain maximum flexibility which would allow it to terminate the lease at the end of its 5-year term, to purchase the cylinders during the period of the term or to allow the lease to continue in effect after the expiration of the term unless terminated by Mr. Hauptli. Of course, Mr. Hauptli through his agent Brown Welding had a choice of allowing the lease to continue after its initial term or of terminating it and attempting to negotiate an increased rent with A & R or some third party. Brown Welding, and presumably Mr. Hauptli, would have undertaken to increase the rental if the economics of the business had permitted it during the fourth year or thereafter, but in fact as of the time of trial, the 5-year initial term had been allowed to continue on a year-to-year basis for at least 1 year. It was normal for a lease with a fixed term such as the Hauptli lease to carry a lower periodic rent than the Union Carbide arrangement which could be terminated without notice.

The management agreement between Mr. Hauptli and Brown Welding is dated June 20, 1983, and provides for compensation to Brown Welding equivalent to 25 percent of rentals payable to Mr. Hauptli under any cylinder lease agreement and any renewal thereof. The sale

and security agreement between Mr. Hauptli and Chesterfield appears to be dated February 17, 1984, and provides for the purchase of 1,000 cylinders of specified types and with specified serial numbers for a total price of $141,350. The agreement provided for a cash down payment of 10 percent with the balance payable in 120 monthly installments commencing in March 1984. However, the cylinder order specification sheets, pursuant to which the cylinders were ordered by A & R from Brown Welding, are dated October 21, 1983, and reflect shipping dates in November and December 1983, for 1,000 cylinders. The parties have stipulated, and we find, that the 1,000 cylinders which are the subject of this case were purchased by Mr. Hauptli through Brown Welding for lease to A & R pursuant to the October 21, 1983, lease agreement. Mr. Hauptli had no obligation to purchase any cylinders prior to entering into the lease with A & R, and it was his intent to purchase these specific cylinders in order to comply with his obligations as lessor to A & R. The cylinders were actually delivered directly to A & R by the manufacturer in December 1983, and were placed in service during the calendar year 1983.

OPINION

Petitioners' entitlement to investment credit in this case depends in part upon compliance with the provisions of section 46(e)(3) which applies to noncorporate lessors. Insofar as pertinent to this case, section 46(e)(3) provides:

> A credit shall be allowed by section 38 to a person which is not a corporation with respect

> to property of which such person is the lessor only if –
>
> * * *
>
> (B) the term of the lease (taking into account options to renew) is less than 50 percent of the useful life of the property, * * * .[2]
>
> * * * For purposes of subparagraph (B), in the case of any recovery property (within the meaning of section 168), the useful life shall be the present class life for such property (as defined in section 168(g)(2)).

Again insofar as pertinent, section 168(g)(2) specified that

> The term "present class life" means the class life (if any) which would be applicable with respect to any property as of January 1, 1981, under subsection (m) of section 167 * * * . If any property * * * does not have a present class life within the meaning of the preceding sentence, the Secretary may prescribe a present class life for such property which reasonably reflects the anticipated useful life of such property to the industry or other group.

In this context, subsection 167(m)(1) specifies that, with respect to property which is included in a class for which a class life has been prescribed, a depreciation deduction is allowed based on "the class life prescribed by the Secretary which reasonably reflects the anticipated useful life of that class of property to the industry or other group."

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[2] Respondent concedes that petitioners met the 15-percent test which is also a part of section 46(e)(3)(B).

These statutes require that we determine the term of the lease and the useful life of the property and match the two in order to ascertain whether or not the term of the lease is less than 50 percent of the useful life. To determine the useful life we go to the class life system in order to ascertain whether or not there is a class life prescribed by the Secretary. Respondent has taken the position that the cylinders fall within Asset Guideline Class 57.0 entitled "Distributive Trades and Services" as prescribed in Rev. Proc. 83-35, 1983-1 C.B. 745, 762, which is applicable to property placed in service in 1983. Petitioners argue that there is no Asset Guideline Class applicable to rental of gas cylinders and thus that Rev. Proc. 86-36, 1986-2 C.B. 596 applies. That Rev. Proc. specifies solely for the purpose of determining the maximum term of a lease permissible under section 46(e)(3) that where there is no applicable class life prescribed in Rev. Proc. 83-35, the estimated useful life of the property should be determined in accordance with traditional rules, i.e., the actual useful life of the property in the trade or business. Petitioners thus argue that the useful life is not less than 35 years. On the other hand, Asset Guideline Class 57.0 prescribes a useful life of 9 years.

Respondent contends that the term of the lease is not 5 years but for an indeterminate period. However, if respondent is correct that the useful life is 9 years based on Asset Guideline Class 57.0, then the term of the lease, which is at least 5 years, violates the less than 50-percent requirement of section 46(e)(3)(B). For the reasons which follow, we agree with respondent that the proper class is Asset Guideline Class 57.0 and for that reason we need

not reach respondent's alternative position that the term of the lease is indefinite.

The Asset Depreciation Range (ADR) System was adopted by the Treasury Department and published in the Federal Register on June 22, 1971, as section 1.167(a)-11 of the Income Tax Regulations. It was explained in Announcement 71-76, 1971-2 C.B. 503. One of the purposes of the ADR system was to shorten useful lives, thereby liberalizing the depreciation deduction. Announcement 71-76, 1971-2 C.B. at 523. The most significant of the principle additions to the depreciation regulations made by ADR was that machinery and equipment placed in service after December 31, 1970, may be depreciated over useful lives from a range of years selected by the taxpayer between 20 percent below to 20 percent above the guideline lives established by the Treasury Department in 1962.

Rev. Proc. 62-21, 1962-2 C.B. 418, established lives for groups of depreciable assets used by businesses in general. The guideline lives were based on general industry experience and reflected the theory that similar assets used by competitive taxpayers within the same industry would tend to have similar useful lives. Announcement 71-76, *supra*. For nonmanufacturing activities Rev. Proc. 62-21 established "a single guideline class" for each industry. This class was intended to include all depreciable property not covered by another specific guideline class. In those instances where more than one guideline class was specified for a particular industry, each class was intended to cover that portion of the total depreciable property appropriate to the particular class. Class 8 styled "Wholesale and Retail Trades" established a 10-

year life. This class included "purchasing, selling, and brokerage activities at both the wholesale and retail level and related assembling, sorting, and grading of goods." Rev. Proc. 62-21, 1962-2 C.B. at 420-422. There was no class covering rental of gas cylinders. Rev. Proc. 71-25, 1971-2 C.B. 553, established asset guideline classes, guideline periods, depreciation ranges, and guidelines class repair allowance percentages related to the ADR system for depreciation of certain classes of assets placed in service after December 31, 1970. The equivalent to guideline class 8 in the 1962 guidelines appeared in this Rev. Proc. as a guideline class 50.0 which covers

> Wholesale and retail trades: Includes assets used in carrying out the activities of purchasing, assembling, storing, sorting, grading, and selling of goods at both the wholesale and retail level. Also includes assets used in such activities as the operation of restaurants, cafes, coin-operated dispensing machines, and in brokerage of scrap metal. [Rev. Proc. 71-25, 1971-2 C.B. 553, 565.]

The asset guideline period established for this class by this Rev. Proc. was 10 years. Rev. Proc. 83-35, 1983-1 C.B. 745, establishes the asset guidelines classes applicable for the year 1983. It is in this Rev. Proc. that we find guideline class 57.0, which "includes assets used in wholesale and retail trade, and personal and professional services. Includes section 1245 assets used in marketing petroleum and petroleum products." This class 57.0 is the equivalent or successor to class 8 in the 1962 Rev. Proc. and class 50 of the 1971 Rev. Proc. The language changes are of no material significance.

Examination of Rev. Proc. 83-35 fails to disclose any guideline class specifically describing the rental of steel cylinders for the storage of compressed gases. However, it does not appear that petitioners' activity in the rental of these steel cylinders is the proper activity for our focus. Respondent's regulations provide that: "In the case of a lessor of property, unless there is an asset guideline class in effect for lessors of such property, the asset guideline class for such property shall be determined as if the property were owned by the lessee." Sec. 1.167(a)-11(e)(3)(iii), Income Tax Regs. Petitioners take note of this regulation but interpret it to refer to the ultimate consumer of the gas who is the sublessee from A & R. We on the other hand interpret the word "lessee" in this context to refer to the entity which is actually using the cylinders in its gas distribution business which is A & R. This result is entirely consistent with the fact that Mr. Hauptli went into the transaction and acquired the 1,000 cylinders which are the subject of this case with the purpose and intent of leasing those cylinders to A & R. The parties have stipulated that A & R is engaged in the "welding supply business" which business has three major categories. We find no asset guideline class which specifically applies to the welding supply business or to any of these principal categories of the business of A & R other than class 57.0 which applies in general to wholesale and retail trades. We conclude that the proper guideline class is 57.0 and thus the useful life of these cylinders is deemed to be 9 years. Petitioners' [sic] argue that the term of the cylinder lease is 5 years and there is no basis for finding a shorter term. Hence the term of the lease

exceeds the limitation of section 46(e)(3)(B) – 5 years is more than 50 percent of 9 years.

We have fully considered petitioners' other arguments including their alternative positions that guideline class 49.21 applying to "Gas Utility Distribution Facilities" or asset guideline class 34.0 entitled "Manufacture of Fabricated Metal Products" should apply. We find no merit to those arguments.

Petitioners have also reargued on brief that Exhibit 8 which is a copy of the examination report issued to petitioners should be admissible in order to demonstrate that respondent's reliance on asset guideline class 57.0 is a new issue and the burden of proof would be upon respondent. We decline to reverse our ruling excluding Exhibit 8. The revenue agent's report has no necessary relationship to or bearing upon the statutory notice issued to a taxpayer. What we are concerned with is the provisions of the statutory notice issued in this case which we find to be amply broad to raise the issue of the useful life of these cylinders. But we have not decided this case on the burden of proof. We have based our conclusions on the entire record in this case which fully supports our findings of fact.

Decision will be entered for the respondent.

APPENDIX G

T.C. Memo. 1991-269

UNITED STATES TAX COURT

JAMES N. RUSSELL AND MARILYN B. RUSSELL, Petitioners *v.* COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 27660-87 Filed June 12, 1991.

Held: The term of the leases of gas cylinders owned by petitioners was indefinite, and thus for purposes of section 46(e)(3)(B) the term was not "less than 50 percent of the useful life of the property." *Hauptli v. Commissioner,* T.C. Memo. 1988-518, revd. and remanded 902 F.2d 1505 (10th Cir. 1990), T.C. Memo. 1991-72 (on remand), controlling.

Thomas J. Kennedy, for the petitioners.

Dale P. Kensinger, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

WHITAKER, *Judge*: Respondent determined a deficiency in petitioners' Federal income tax liability for the calendar year 1983 in the amount of $2,842. The sole issue for decision is whether petitioners are entitled to an investment tax credit under section 46(e)(3)(B)[1] in connection with the purchase during 1983 of compressed gas

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[1] Unless otherwise noted, all section references are to the Internal Revenue Code of 1954 as amended and in effect for the years in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure.

cylinders for lease to unrelated parties. More specifically, as applied to this case, we must decide whether the terms of the leases entered into are less than one-half of the useful life of the property.

FINDINGS OF FACT

Some of the facts have been stipulated, and they are so found. This case is related to the investment at issue in *Hauptli v. Commissioner,* T.C. Memo. 1988-518, revd. and remanded 902 F.2d 1505 (10th Cir. 1990), T.C. Memo. 1991-72 (on remand), wherein we found on remand that lease terms identical in all material respects to those at issue herein were indefinite for purposes of section 46(e)(3)(B) and thus that the taxpayers there did not qualify for the investment tax credit. The facts in our *Hauptli* opinions, and the record in that proceeding, are hereby incorporated by this reference to the extent pertinent herein. Petitioners, who are husband and wife, resided in Northfield, Illinois, when their petition was filed.

Prior to and during 1983, Brown Welding Supply, Inc. (Brown Welding), promoted investments to a number of individuals by means of which the investors could purchase compressed gas cylinders from manufacturers and, pursuant to agreements with Brown Welding for the management and leasing of the cylinders, lease the cylinders to third parties. Petitioner James N. Russell became involved in one such investment. On March 21, 1983, he entered into an agreement with Brown Welding whereby he retained Brown Welding to assist in the purchase, repair, maintenance, valving, shipping, and renting of

cylinders. In April 1983 petitioner, through Brown Welding, purchased 1,500 compressed gas cylinders from Chesterfield Cylinder Company, Inc. (Chesterfield), for a total amount of $212,750. The purchase was financed by petitioner's payment of 10 percent in cash, with the remainder payable in installments that totaled $2,766 per month, pursuant to three security agreements between petitioner and Chesterfield. Petitioner's obligations under the security agreements were satisfied in full on April 20, 1987, and July 31, 1987. On September 22, 1982,[2] petitioner entered into an agreement to rent the cylinders to Coulter Welding Supply, Inc. (Coulter), and on October 1, 1982, petitioner entered into a similar rental agreement with Greene Welding Supply, Inc. (Greene). Coulter and Greene were unrelated parties dealing at arm's length with petitioner through Brown Welding. Coulter and Greene are each engaged in the welding supply business, and their major business categories are: (a) The sale of welding and cutting equipment, industrial tools and products, and electrodes and supplies (48 percent of revenues); (b) the sale of industrial, medical, and specialty gases (31 percent of revenues); and (c) the rental of compressed gas cylinders (17 percent of revenues). The remaining 12 percent of revenues is derived from delivery charges.

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[2] Because the parties have not done so, we attach no significance to the fact that the rental agreements were entered into prior to petitioner's agreement with Brown Welding or petitioner's purchase of the subject cylinders. Under the terms of the rental agreements, petitioner was not obligated to deliver any cylinders if unable to do so.

Under the rental agreements with Coulter and Greene, petitioner agreed to rent compressed gas cylinders in exchange for per cylinder rental fees that totaled $2,645 per month, subject to cost of living adjustments.[3] At no time could the rental exceed 70 percent of the rental charged by a company related to Union Carbide, which was a dominant supplier of cylinders and the gases contained therein at the time. Petitioner was to pay 25 percent of the rental payments he received to Brown Welding. The lessees had options to purchase any or all of the cylinders at then-current prices adjusted in relation to the number of months the lessees had made payments under the leases. With regard to the length of their terms, the rental agreements provided in pertinent part:

> 2. This Agreement shall be effective as of the date hereof. The initial term of this agreement shall be five (5) years ("Initial Term") from the Delivery Date specified in Paragraph 4 of this Agreement, *and shall remain in force from year to year after the expiration of the Initial Term until terminated as hereinafter provided.* Either party may terminate this agreement as of the expiration of the Initial Term or as of any annual

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[3] There appears to be an unexplained discrepancy in the record between the total number of cylinders purchased by petitioner (1,500) and the number leased by him to Coulter (1,000) and Greene (1,000). In connection with the Coulter lease, petitioner purchased 1,000 cylinders and agreed to lease the same number of cylinders to Coulter. However, in connection with the Green lease, petitioner purchased 500 cylinders, yet apparently was responsible for supplying Greene with 1,000 cylinders. We note in connection therewith that the Greene lease was entered into by petitioner and the Delmas A. Jackson Trust as lessors, and we assume that the Trust supplied the other 500 cylinders.

> anniversary date thereafter by giving not less than twelve (12) months prior written notice to the other party. [Emphasis added.]

The leases contained no option to renew. At the time the leases were entered into, there was no predetermined plan as to whether the leases would remain in effect at the end of the initial term or would be terminated by either party.

The compressed gas cylinders at issue are portable and weigh between 116 and 146 pounds each. They consist of a metal cylinder, with collar and cap, fitted at one end with a replaceable valve for regulation of the flow of gas. They were ordered in a variety of colors specified by Coulter and Greene. They were marked with the name "Coulter Welding" and "Greene Welding." Each cylinder is identified by a serial number stamped thereon. The gas cylinders, other than the attached valves, have no movable parts and are quite durable. They have a physical life of over 35 years unless lost or unusually damaged. All 1,500 of petitioner's cylinders were placed in service in 1983. The gas cylinders leased by petitioner to Coulter and Greene were delivered directly from the manufacturer to the lessees. The cylinders leased by petitioner to Coulter and Greene were released on a monthly basis by Coulter and Greene to their customers to store the gases which they purchased from Coulter and Greene.

Petitioners filed their Federal income tax return for the taxable year 1983 on May 31, 1984. It was prepared on the cash receipts and disbursements method of accounting. On that return petitioners claimed an investment tax credit in the amount of $22,216, $21,275 of which was

based upon Mr. Russell's purchase and lease of the aforementioned gas cylinders. On May 19, 1987, respondent timely issued to petitioners a notice of deficiency which disallowed the portion of the investment tax credit taken on petitioners' 1983 return that was in connection with the gas cylinders.

Petitioners timely filed a petition with this Court. In their petition, petitioners alleged that respondent incorrectly disallowed their investment tax credit, that assessment of the deficiency was barred by the statute of limitations, and that respondent erred in conducting a second inspection of petitioners' book of account in violation of section 7605(b). The parties have stipulated that respondent properly instituted the examination of petitioners' income tax liability for 1983 as required by section 7605(b) and that the notice of deficiency upon which the instant case is based is not barred by the statute of limitations. They also have stipulated that the testimony in *Hauptli v. Commissioner,* T.C. Memo. 1988-518, of Mr. Stewart R. Horejsi, the president of Brown Welding, is admissible and shall be treated for all purposes as if he had so testified herein. They additionally have stipulated that the deposition of Mr. Bruce Howard, who was a principal of the lessee in *Hauptli v. Commissioner, supra,* is admissible and shall be treated as if it were the testimony of the principals of Coulter and Greene herein.

OPINION

The parties are in agreement that the sole issue to be decided herein is whether petitioners are entitled to an investment tax credit under section 46(e)(3) in connection

with Mr. Russell's purchase of the cylinders. That section allows an investment tax credit to a noncorporate lessor only where either the property subject to the leases has been manufactured or produced by the lessor (which is not the case here), or where the terms of the leases are less than 50 percent of the useful life of the subject cylinders.[4] Thus, our determination depends upon our findings concerning the terms of the leases and the useful life of the cylinders for purposes of section 46. For the reasons stated below, we need only to reach the first question as to the terms of the leases, for in this case it is dispositive.

In our decision on remand in *Hauptli v. Commissioner,* T.C. Memo. 1991-72, we concluded that the leases before us (which were identical in all material respects to those at issue here) were for an indefinite term. Consequently, leases with indefinite terms were in excess of one half of the useful life of the cylinders (regardless of its duration) and, therefore, the cylinders at issue did not qualify for the investment tax credit. We found the leases to be indefinite because: (1) The leases provided that "after the initial term [they] would continue from year to year until terminated"; and (2) "there was no understanding or agreement between the parties to the leases as to whether the leases would be allowed to continue in effect or be terminated at the end of the 5-year initial term." *Hauptli v. Commissioner,* 61 T.C.M. at 1965, 60 P-H Memo T.C. par.

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[4] The parties have stipulated that the other requirement of section 46(e)(3)(B), that the deductions allowed to the lessor under section 162 exceed 15 percent of the rental income produced by the property, has been met.

91,072 at 358 (quoting *Hauptli v. Commissioner*, 56 T.C.M. 583, 585, 57 P-H Memo T.C. par. 88,518 at 2649). In reaching our conclusion that the leases were indefinite, we relied in part upon our opinion in *Ridder v. Commissioner*, 76 T.C. 867 (1981), which held that a lease with no fixed term that could be terminated upon 30 days' notice or upon mutual consent of the parties was indefinite. We also applied the "realistic contemplation" of the parties test of *Borchers v. Commissioner*, 95 T.C. 82, 88 (1990), to conclude that the leases were for an indefinite term. We reach the same conclusion here.

Petitioners argue that the testimony of Mr. Horejsi, the president and chief executive officer of Brown Welding, shows that petitioner (through Brown Welding) intended to renegotiate the price at which the cylinders would be rented at the end of the 5-year initial term. This requires us, they contend, to treat the lease as being subject to a 5-year term. However, we do not read Mr. Horejsi's testimony to say that the leases would clearly be terminated at the end of the initial term; rather, he stated that "it was our intent that as soon as we felt the economic conditions would allow, we intended to get our rental rate back up to the same rate that Union Carbide was charging." Economic conditions being what they are, we cannot read this self-serving statement to be a clear expression of Brown Welding's or petitioner's intent at the time the leases were entered into to cancel the leases at the end of the 5-year initial term and renegotiate the leases at a higher price. To the contrary, the testimony of the president of the lessee in *Hauptli v. Commissioner*, *supra*, which the parties have stipulated to be the same as the positions of the lessees here, indicates that the lessees

did not have any fixed intention one way or the other at the time they signed the leases. Accordingly, petitioners have failed to convince us that the parties' "realistic contemplation" was to terminate the leases at the end of the initial term. Thus, they have not succeeded in demonstrating that they have met the 50 percent requirement of section 46(e)(3)(B) for the same reasons as we stated in our *Hauptli* opinion on remand.

Despite the identical nature of the facts before us and those in *Hauptli v. Commissioner, supra,* petitioners argue that the outcome of the instant case should be different because the Seventh Circuit (the circuit to which an appeal in the instant case would lie) in *McNamara v. Commissioner,* 827 F.2d 168 (7th Cir. 1987), vacating and remanding a Memorandum Opinion of this Court, held that a lease with a fixed term of less than 50 percent of the useful life of the subject property should not be disregarded unless the lease was a "sham." 827 F.2d at 172. The Court of Appeals for the Seventh Circuit held that the "realistic contemplation" of the parties that the lease may be renewed beyond its stated term would not cause that Court to disregard the stated term of the lease unless there was some evidence that all economic risks of the underlying property had been shifted to the lessee. The appeals court then vacated and remanded the case to the Tax Court to determine whether the leases were "shams" – i.e., whether there was a fixed intention to renew the leases "on the same or substantively identical terms." 827 F.2d at 172. Petitioners here contend that we must follow *McNamara* and should hold that the leases were not shams and that, under the "economic risk" rule of that case, the economic risks of owning the cylinders

were not shifted with certainty from petitioner to his lessees for any period beyond the 5-year initial term. Respondent urges that he is not seeking to ignore the stated terms of the instant leases but would treat the leases as indefinite by their very terms. Accordingly, he contends, *McNamara*, if anything, emphasizes that the express terms of the leases are controlling and should be disregarded only in carefully defined circumstances.

We hold that *McNamara* is distinguishable from this case because the terms of the leases are materially different.[5] In *McNamara*, the lease was for a fixed term that was less than 50 percent of the useful life of the property, and it had to be negotiated anew upon expiration of that term. 827 F.2d at 170. In the instant case, the leases were not for a fixed period; they expressly provided for an "initial term" and then *"remain[ed] in force * * * until terminated."* (Emphasis added.) At the end of the 5-year initial term, the parties herein had the options of ending the lease relationship, renegotiating the lease terms, or doing nothing. If they did nothing the leases continued to be in force. Thus, unlike in *McNamara*, there is no "renewal" for us to predict – no renewal was necessary because the leases did not end at a fixed termination date. Accordingly, there is no need to determine whether we should disregard the leases as "shams" as respondent

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[5] See *Perry v. Commissioner*, T.C. Memo. 1987-447, affd. 855 F.2d 859 (8th Cir. 1988), distinguishing *McNamara v. Commissioner*, 827 F.2d 168 (7th Cir. 1987), vacating and remanding a Memorandum Opinion of this Court, on the same ground. For the same reason, we hold that our decision in *Sauey v. Commissioner*, 90 T.C. 824 (1988), affd. 881 F.2d 1086 (11th Cir. 1989), also cited by petitioners, is inapposite.

attempted to do in *McNamara*; instead we uphold the literal terms of the leases and hold, as we did in *Hauptli*, that they were indefinite.

We further note that *McNamara* did not reject the "realistic contemplation" test in favor of the "economic risk" rule to be applied in all contexts, as petitioners imply in their brief. Rather, the Court of Appeals' holding is expressly applied to the situation where "the stated lease term in a written lease document satisfies the 50 percent requirement" and one of the parties is seeking to disregard the stated fixed term. 827 F.2d at 172. See *Hoisington v. Commissioner*, 833 F.2d 1398, 1404 (10th Cir. 1987), affg. a Memorandum Opinion of this Court (Court does not view *McNamara* as a test for determining length of all lease terms). Thus it is not contrary to *McNamara* to use the "realistic contemplation" analysis here.[6]

For these reasons, the lease terms were in excess of one-half of the useful life of the cylinders, and petitioners do not qualify for the investment tax credit.

Decision will be entered for the respondent.

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[6] The First Circuit does not agree with the *McNamara* decision in the context of a fixed term lease and has held that the "realistic contemplation" test should be used. See *Connor v. Commissioner*, 847 F.2d 985 (1st Cir. 1988), affg. a Memorandum Opinion of this Court. If *McNamara v. Commissioner, supra*, were directly on point, we would, of course, be required to follow it under the rule in *Golsen v. Commissioner*, 54 T.C. 742 (1970), affd. 445 F.2d 985 (10th Cir. 1971). But because of the material difference in the lease terms, *Golsen* does not apply.

APPENDIX H

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 46. AMOUNT OF CREDIT.

* * *

(e) [as redesignated by Sec. 302(a), Tax Reduction Act of 1975, Pub. L. No. 94-12, 89 Stat. 26] *Limitations with Respect to Certain Persons.* –

* * *

(3) [as added by Sec. 108(a), Revenue Act of 1971, Pub. L. No. 92-178, 85 Stat. 497; as amended by Sec. 103(a)(4), Technical Corrections Act of 1979, Pub. L. No. 96-222, 94 Stat. 194; as amended by Sec. 211(d), Economic Recovery Act of 1981, Pub. L. No. 97-34, 95 Stat. 172; as amended by Sec. 5(a)(6), Subchapter S Revision Act of 1981, Pub. L. No. 97-354, 96 Stat. 1669.] *Noncorporate lessors.* – A credit shall be allowed by section 38 to a person which is not a corporation with respect to property of which such person is the lessor only if –

(A) the property subject to the lease has been manufactured or produced by the lessor, or

(B) the term of the lease (taking into account options to renew) is less than 50% of the useful life of the property, and for the period consisting of the first 12 months after the date on which the property is transferred to the lessee the sum of the deductions with respect to such property which are allowable to the lessor solely by reason

of section 162 (other than rents and reimbursed amounts with respect to such property) exceeds 15 percent of the rental income produced by such property.

In the case of property of which a partnership is the lessor, the credit otherwise allowable under section 38 with respect to such property to any partner which is a corporation shall be allowed notwithstanding the first sentence of this paragraph. For purposes of this paragraph, an S corporation shall be treated as a person which is not a corporation. This paragraph shall not apply with respect to any property which is treated as section 38 property by reason of section 48(a)(1)(E). For purposes of subparagraph (B), in the case of any recovery property (within the meaning of section 168), the useful life shall be the present class life for such property (as defined in section 168(g)(2)).